



Theme #10: Pesos no prickly pair

- Cyclical Lat Am FX offers value in an environment of strong US/global growth.
- Stay long MXN vs. USD, COP and RUB on back of FDI inflow pre-pricing and oil production prospects. Long CLP/COP should benefit from terms of trade and political uncertainty in the latter. Stay cautious on BRL because of structural concerns, weak fundamentals and less BCB intervention appetite.

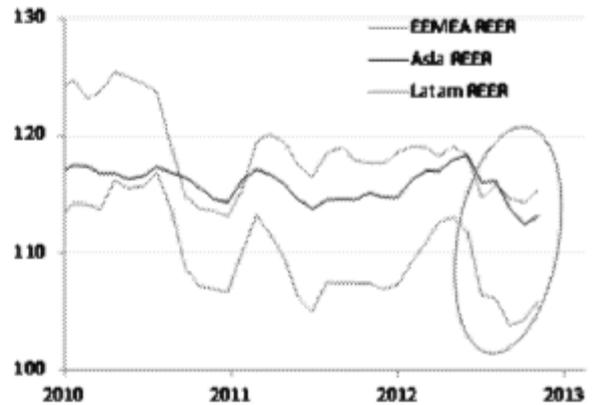
After 2013's *annus horribilis*, we anticipate Lat Am FX to offer more value over the coming months. The reaction to December's Fed tapering decision suggests markets have fully incorporated expectations of higher long-end US yields. Going forward, we expect currency performance to be closer to fundamentals and less sensitive to the re-pricing in US rates. That said, successful forward guidance, at least in the short term, is a necessary condition for Lat Am performance in 2014. Growth surprises in the US should then in principle benefit currencies with strong export exposures that have already seen considerable adjustment. From this point of view, CLP, PEN and MXN have the highest betas to the global cycle with the latter particularly well placed to benefit from an upturn in the US economy.

Despite more favorable valuations and possible upturn in some of the local economies, structural concerns and balance of payments dynamics remain headwinds for the region as whole. Where export-orientated growth is more elusive, such as in the more closed economies of Brazil and Colombia, domestic demand may not be sufficient to provide attractive rates of return for foreign investment against a backdrop of US rate normalization. At the same time, export growth will be insufficient to close current account deficits. Renewed falls in commodity prices also present a risk for COP, PEN and CLP, although our base case is that better China growth will provide a boost for the latter.

Turning to individual currencies, we remain bullish on the Mexican peso. First, the energy reform passed in December is more ambitious than expected. Licenses and production sharing contracts, rather than the originally proposed profit sharing regime, increase the potential for FDI inflows. While we do not expect the first inflows until 2015, academic research into M&A flows and the relationship between exchange rates and commodity prices suggest that FX markets may 'pre-price' expected capital flows meaning that continued momentum over secondary legislation will be more important than deal announcements *per se*.<sup>6</sup> It is worth noting that Mexico has foregone the bonanza in FDI.

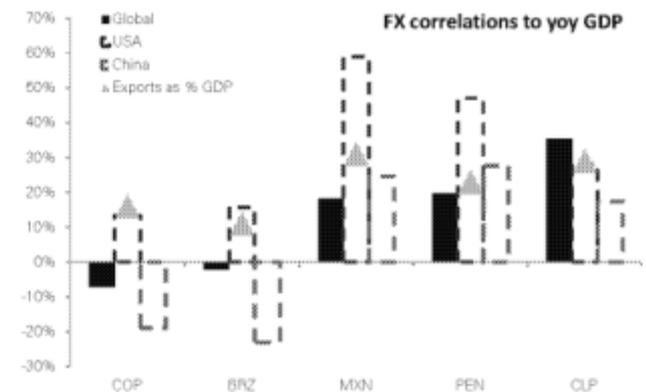
<sup>6</sup> See, for example, DB Commodities Quarterly, *Trading industrial metals ratios in a rising USD environment*, Xiao Fu, June 2013.

A better starting point for valuations



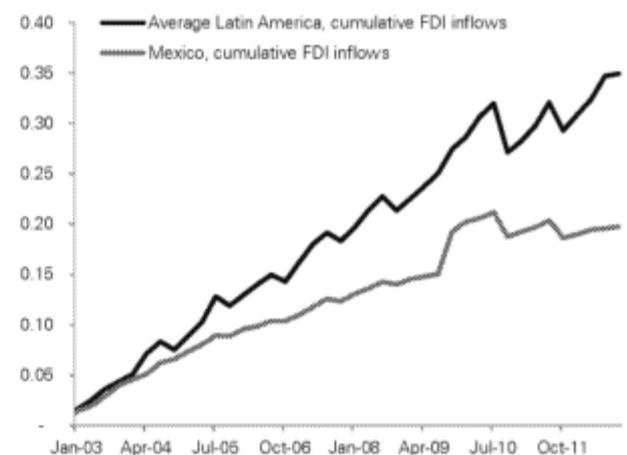
Source: Deutsche Bank

CLP to benefit most from global growth bounce



Source: Deutsche Bank

Mexico should begin to close FDI gap



Source: Deutsche Bank, Bloomberg Finance LP